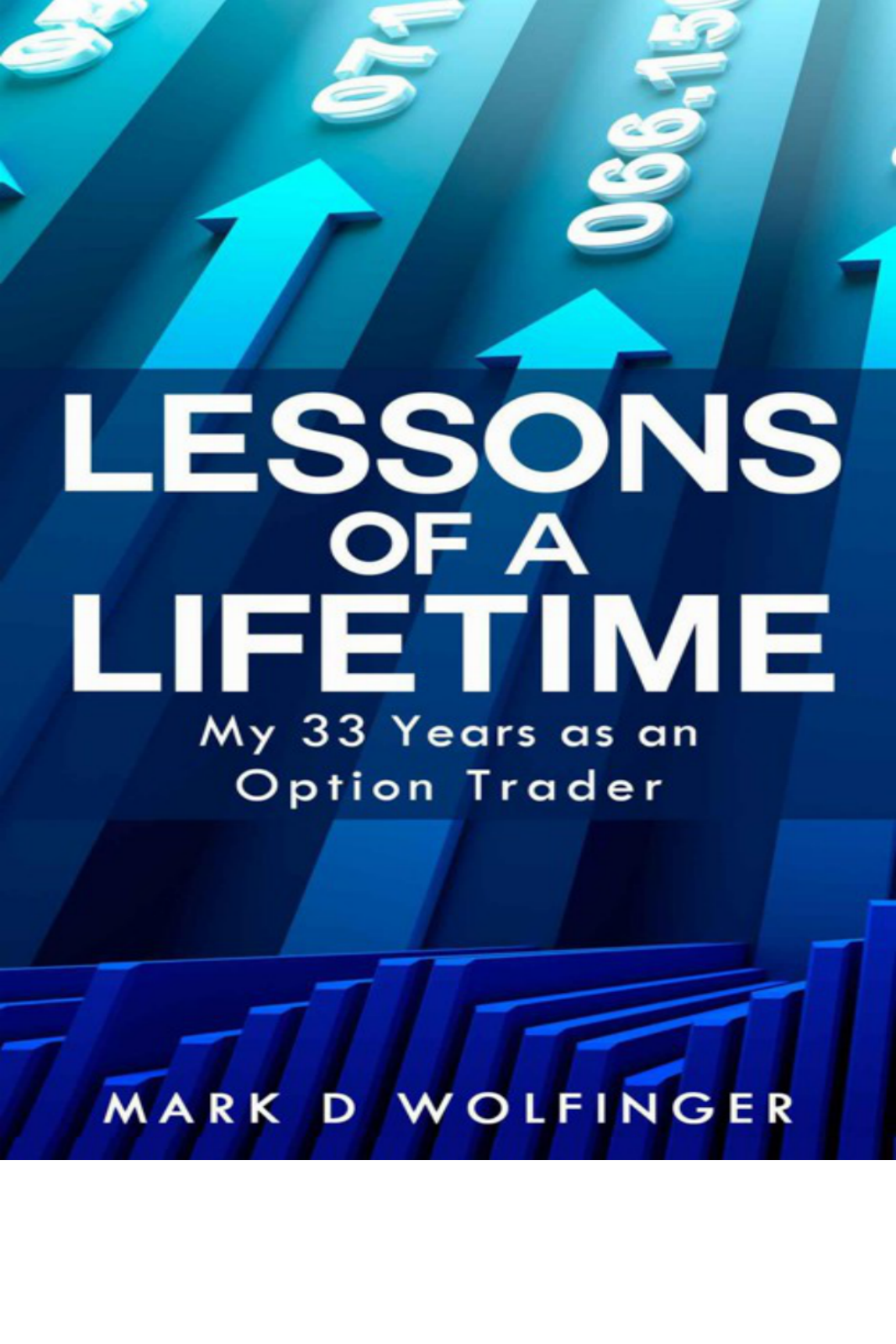


**Lessons of a
Lifetime: My 33
Years as an
Option Trader**

Wolfinger, Mark D

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LESSONS OF A LIFETIME

My 33 Years as an
Option Trader

MARK D WOLFINGER

Lessons of a Lifetime:

My 33 Years as an Option Trader

Mark D Wolfinger

Options for Rookies Books, 2010

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Lessons of a Lifetime: My 33 Years as an Option Trader

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The information presented in this book is for educational purposes only. I neither make nor suggest any specific recommendations for investment. Examples are for illustrative purposes only, and serve to show what may happen in a particular situation. The possible rewards are stated, as are the possible risks. Covered call writing is a sound, conservative investment strategy, but losses can still occur.

Table of Contents

[Introduction](#)

[Chapter One](#) Reality

[Chapter Two](#) Don't Ignore Risk.

[Chapter Three](#) Being Comfortable with your Trade

[Chapter Four](#) Money Management

[Chapter Five](#) Who Wants the Last Nickel?

[Chapter Six](#) Profits are in the Future, not in the Past

[Chapter Seven](#) Exiting a Trade

[Chapter Eight](#) Holding Positions into Expiration

[Chapter Nine](#) Strategy Selection vs. Risk Management

[Chapter Ten](#) Trading Plan and Record Keeping

[Chapter Eleven](#) The Best Decision

[Chapter Twelve](#) You Have a Loss?

[Chapter Thirteen](#) Getting Even

[Chapter Fourteen](#) More on Comfort Zones

[Chapter Fifteen](#) Odds and Ends

[Afterword](#)

[About the Author](#)

[Author's Other Books](#)

Dedication

To Penny who taught me the truly important lessons of a lifetime

Introduction

This book contains a series of commentaries on a variety of topics related to trading options. It's my attempt to share lessons that were learned along the way. Some lessons came easily, while others had to be repeated before I even *considered* altering my way of doing things. I've also developed some ideas about trading that are not in accordance with mainstream thinking. Those ideas are included in the book.

I began trading options as a professional in 1977. I'm not so egotistical to believe that these ideas are gospel and that if you fail to follow them you are doomed to failure.

Rather, this is my method for sharing important lesson's that I've learned. This book is clearly not comprehensive. It was written with the hope that you can spare yourself some of the anguish that I experienced when learning these truths. Okay; I shouldn't exaggerate. They are truths to me, and not every lesson will be suitable for you, your investing style, your risk tolerance, comfort zone boundaries, etc. But, they are helpful to me and I hope they will be helpful to you.

Some topics are mentioned more than once. That's the result of the way this book was compiled. It was not written as a separate book. Instead, it's a collection of ideas. Most chapters are 100% new. A small number were previously published or discussed in my books or blog. But each was rewritten, updated, or modified in some way. The writing is fresh.

This book is not filled with trading lessons. It is filled with my philosophical ideas, or my way of looking at options related situations that I encounter. I believe this way of looking at the world will help you make those difficult decisions when you are faced with them. I know they guide me through both normal and difficult times. If you gain confidence in your ability to think through a problem, or recognize that something you always thought to be true may be worth further consideration, then this book will have served its purpose.

There are always life lessons to be learned. This book does not contain *the* definitive way to view the world. Indeed, some readers will strongly disagree with at least one of my tenets. But that's a good thing. If this book achieves no other purpose than having you reconsider the way you approach decision-making or view the world,

then something positive has been accomplished. It's not necessary that you change your mind. The fact that you take the time to reconsider – regardless of whether you change your way of seeing a specific situation, or continue as before - is valuable all by itself. It gives you increased confidence in your ability to be successful in your trading career. And confidence is an important quality for a trader. Confidence, not overconfidence.

To that end, I wish you good trading.

Evanston, IL
March 2010

Chapter One

Reality

"The only function of economic forecasting is to make astrology look respectable." - John Kenneth Galbraith

There's always more than one way in which each of us perceives certain events. Part of the time there is room for interpretation because the 'facts' can be considered from different points of view. Sometimes, there is only a single 'truth.' Yet that truth can be elusive.

Consider what happens when the police debrief eyewitnesses to a crime. I don't believe anyone thinks there is more than one version of the truth. It's possible that people standing in different places may have a view not visible to everyone, but only one event took place. There is one complete and accurate description. The getaway car cannot be blue, green and black at the same time. Some witnesses swearing to those colors do not recall events with accuracy.

Yet, each witness is positive that he/she is accurately describing the truth and accurately reporting a complete and correct description of reality. When those reports are compared, it's obvious that most witnesses reported details that are inaccurate.

It's not easy for those of us who were not present at the scene to understand why this happens. This is especially true when each witness is *certain* he/she is correct.

There's more to the story. There is evidence that shows that as time passes, each witness becomes even more certain that his/her story is true. The passage of time makes our 'memories' deepen, even if they are not accurate memories.

There is only one reality, but discovering the details is not always easy.

What is it that makes each of us cling to our version of events when there is overwhelming evidence that our version is inaccurate? Is it a bias that makes people certain that what they believe to be true - is

true? Is it easier to believe your own eyes (or mind) than those of someone else?

Is this certainty based on logic? If you saw something happen and vividly remember the event, can your version of the facts be anything but true? And if others, offering a different account of the events are just as certain they are correct, would that raise doubts in your mind? Most people stick to their stories because they 'know' them to be true, and the ideas of others are ignored.

Each of us believes that the others must be mistaken, despite an assurance on their part that they are not. You know what's true, and in your mind, that's all there is to know.

Is it the same when the certainty involves something that was not seen, but which you believe to be true? Perhaps it's something you learned as a child and trusting your parents or teachers, you never questioned. For example: 'don't get chilled, or you will catch cold.'

On a more serious note, it can be something we learned in our religious upbringing. Because different religions teach different interpretations of similar events, they cannot all be accurate. Yet each group believes his/her group is the only one with the right answer.

The bottom line is that when you 'know' something is true, it's very difficult to accept a mindset that offers a different version of reality. Examples: 'the earth is flat' or 'the earth is the center of the universe.' Each of those statements was 'obviously' the truth – until scientific evidence convinced people that it was no longer obvious.

Example from my world

If I were to tell you (and I will, if given the chance) that careful risk management is essential to success as a trader, everyone recognizes that this is an opinion, and not a statement of fact. I believe it to be true. I know it's true for me. But I have no way to prove that it's true for you, let alone for everyone else. Yet I frequently write that opinion as if it were the truth, the whole truth, and that any disagreement is irrational. Those who disagree with the premise frequently see no reason to argue. It's easier to disregard such an opinion when you have no use for it.

There are more simple examples that are either true or untrue. You either believe it or you don't. These situations are based on logic. One of my favorite bits of illogical thought is the argument:

If I don't sell my asset, I cannot have a loss.

A loss only occurs after I exit the trade and have no chance to recover.

To me, these statements are false. I cannot understand how any logical mind believes it to be true. If you paid \$10,000 for that asset (on date 1) and the current (date 2) market value is \$5,000, then you lost \$5,000. I use the past tense. The money is lost. Sure, it can be recovered. It may not be a losing trade forever. But right now, your account is missing that \$5,000 and it's a loss.

If that asset is soon worth \$6,000 on date 3, then these statements are all true

- You had a loss of \$5,000 on date 2
- Your loss is \$4,000 when looking at the trade on date 3
- You lost \$5,000 as of date 2; you earned \$1,000 between dates 2 and 3

There is no contradiction. You can look at your position in any manner that suits you, but if you deny that it's a loss, you are making an error. Why this matters is discussed below.

Consider our language and the way we talk about ideas. Consider a baseball game. You ask the score, and someone may tell you that 'the home team is winning 2-1.' Someone else may say 'the home team is leading 2-1.'

There are obviously other choices, but look at the language. The first person is stating that the home team is on its way to victory. 'Winning' is a condition that results in a win. I don't see how you can be 'winning' if you lose at the end.

The second is stating that the home team currently has an advantage, but there is no statement about the potential outcome of the game. The home team can easily be 'losing,' but currently has a higher score than its opponent. If one could see the future, the description might be

“The home team is losing the game, but at the moment they are ahead.”

To some people this is a quibble and they understand that idiomatic language is often responsible for phrases that are not literally accurate. For example: ‘Comment allez vous?’ or ‘How’s it going?’ That question has nothing to do with travel or movement. It’s a general question about life: Are you well? Or how are you feeling? Those are the general interpretations. The common reply is ‘fine,’ and is never ‘I’m taking the bus.’

A large percentage of the population believes that if you still own that depreciated asset, stock, option, or home - that no money has been lost simply because it has not been sold. The US Internal Revenue Service helps propagate that myth. One can only take a tax deduction for realized losses, and any unrealized losses – such as that \$5,000 item that you own – are not recognized by the IRS as a loss. For professional traders, this is not true. Their positions are marked to the market at year end. Unrealized gains and losses are taxed as if they were realized gains and losses.

Here’s how I look at it:

- Your account values this item at \$5,000
- If the account is with a broker, you may only borrow based on that \$5,000 valuation. The \$10,000 valuation is imaginary
- If you lose other money and receive a margin call, your broker will show no tolerance for your argument that the account is really worth \$10,000 and that it’s not fair to value it at \$5,000
- If you want to make a withdrawal from your account, your broker will not allow you to take \$10,000
- If it’s a house, your bank will not give you a \$10,000 mortgage based on your estimated valuation

The rest of the world values that asset at \$5,000 and if you refuse to agree that \$5,000 has been lost, then in my opinion you have no respect for reality. Money has been lost. That’s reality.

So who cares? It’s only semantics

This specific problem represents a very important situation in today's economic reality. I'm sure you are not interested in my political beliefs, but the current mark-to-the-market argument is based on this discussion.

The major banks are allowed to pretend that their assets are worth every penny that they claim they are worth. Yet, if they tried to sell those assets, they would not bring 50 cents on the dollar. Some wouldn't fetch 10 cents on the dollar. Yet the banks are not forced to mark to the market.

You and I are forced to do so by our brokers, but not the big boys. They have their own rules.

By some estimates each of the largest banks in America are, and have been, insolvent for years. Their assets are simply not worth what they claim. If they were forced to mark to the market, as everyone else must, they would be insolvent and out of business. Whether that would be a disaster or a necessary step towards recovery is not the point. The point is that the banks can claim their multi-trillion dollar investment is still worth that much when it isn't.

To me, the stance of the IRS, along with some giant banks not being forced to mark to the market, gets intelligent people to believe that a loss is not really a loss until such time as they decide to sell the position.

One disrespected ex-baseball player turned investment advisor claims a record of 140 wins and zero losses simply by adding to, and refusing to exit, any losing trade. He's in bankruptcy, but claims to make only winning trades. The reality of his financial condition lets everyone understand the truth.

Lesson: A loss is a loss. Refusing to believe something is true does not change the facts. When trading, it's important 'to thine own self be true' [From Hamlet: Advice from Polonious to his son, Laertes.] You must recognize which trades and trading decisions lead to profits and losses - so you can learn from your experience. Like many other skills that are developed over a lifetime, trading is a skill that benefits from practice. Not half-hearted practice, but a true effort to learn from mistakes and become more skillful. If you lie to yourself about where you make and lose money, you are not going to gain much from the lessons learned along the way. Because those 'lessons' will be partially based on fiction.

Chapter Two

Don't Ignore Risk

“Self-regulation bears the same relationship to regulation that self-importance does to importance.” Paul Kedrosky

Risk is not your friend, but it is an essential aspect of trading. There are no financial rewards without financial risk. For taking more risk, an investor demands, and receives, the opportunity to earn a larger reward.

Options are unique in the investing universe. Yes, they have a limited lifetime and thus, expire at some point in the future. But, it's the ability to quantify risk that sets options apart from other investment tools. When you can measure risk, you can manage it. The “Greeks” represent specific risk parameters that can be quantified.

It's true that stockholders can measure delta (one of the Greeks.) It's simply the number of shares owned. To protect against a decline in the stock price, the only realistic hedge is to sell a portion of those shares. However, when options are added to the picture, alternatives become available.

As an example, the collar strategy is often employed by investors whose major investment objective is the preservation of capital. Earning profits is important, but not the primary objective. The collar is an effective strategy for gaining absolute protection against a calamity, but in return, upside profit potential is limited. The best feature for collar traders is that this protection can be had for little or no cash out of pocket. In fact, it's often true that the investor collects a cash payment when establishing the collar. [This happens when the proceeds from the call sale exceed the cost of buying the the put.]

Less conservative investors may be uncomfortable with no opportunity to earn large profits. They prefer to accept greater risk of loss in exchange for the chance to capture a large gain. Other strategies are

available to them. Sometimes, but not often, insurance policies (puts) can be purchased at reasonable prices. Modified covered call writing strategies can be used to generate income and still allow for substantial profits. For example, write a call spread instead of writing a call. That entails owning stock, selling a call, and buying another, farther out of the money call.

Another way to limit risk is to unload stock and buy call options. This idea limits losses to the cost of the calls, but it's a costly play. To profit, the stock must rise by more than the time premium in the calls -- Plus even more, when the call option is out of the money. This method is appropriate for those who insist on being bullish but who are afraid of the downside. Selling stock and buying calls is equivalent to buying puts for protection. Too many investors buy puts to insure a stock portfolio, but don't appreciate just how inefficient and costly that can be.

Owning options comes with risk

Each of those strategic ideas comes with its individual type of risk. When owning puts and/or calls, time decay is an issue. As wasting assets, option values decline over time. One reason investors own options and are willing to pay that time decay, is that losses are limited to the cost of owning the option. That's far less risk than faced by someone who owns shares of stock.

Option prices fluctuate over time, and one of the most influential factors that determine the current value of an option is its implied volatility. Part of the time, markets are calm and there is not a great deal of buying interest. Supply (willing option sellers) exceeds demand for options and prices gradually decline. That's a period of low implied volatility.

At other times, and especially when the markets are declining, there's an increased demand for both put and call options. [When put prices soar due to an increase in implied volatility, if call prices failed to rise, sophisticated traders understand that they can buy calls instead of puts. By selling short 100 shares of stock for each call purchased, the trader owns a synthetic put. It provides every bit as much protection as a 'real' put.] With fewer option sellers, prices rise, and occasionally the prices move to extreme levels (Oct 1987, Nov 2008). That's a period of high implied volatility.

If you are unaware of the effect of implied volatility on the pricing of options, you can quickly discover that buying options at the wrong

time is costly. If you buy options in the midst of a mini-panic, option prices may soon plunge, leaving you with the protection you sought, but at a very steep price.

Investors have choices when owning options, and in making those choices, must be aware of the risks.

Versatility

Options are versatile investment tools. But that statement doesn't go far enough. Options provide so many advantages for the average investor that it's a wonder (to me) that more people don't understand how options work and how they can be applied to a myriad of situations to reduce risk. Sure that risk reduction comes at a price – sometimes it costs cash, while at other times one must accept a cap on potential profits to acquire the benefits of adopting option strategies. There are many choices and the investor has the ability to design an option position that offers as much protection (if any) as the investor needs at a cost he/she is willing to pay.

Are you afraid of a disaster, but unwilling to stay out of the market? Consider collars.

Extremely bullish but fear the market can turn on a dime and crash? Buy call options to limit losses.

Expecting a stagnant market? Consider writing covered calls or trading iron condors. The iron condor is for experienced traders and is built by selling one call spread and one put spread (same expiration and underlying stock) at the same time.

There's a reasonable option strategy for every market outlook. You can own insurance against a significant loss – sometimes with a large deductible at a lower cost, or with a tiny deductible at a much higher cost. There's something for everyone.

Summary

It's true that you must accept risk to generate profits, but there is no need to take on more risk than you are willing to accept. Options help you achieve those goals

To decrease risk, there's a price to pay. You either pay for insurance or accept a cap on potential profits. Of course no one is forced to accept less risk. You are free to remain fully invested in the stock market and

take your chances. That's the investing method of the majority. In my opinion, that's the popular choice because investors don't know any better.

Chapter Three

Being Comfortable with Your Trade

“Creditors have better memories than debtors.” Benjamin Franklin

One of my admonishments to all traders is that it's important to maintain positions that fall within your comfort zone. Let's define that zone.

The comfort zone is a behavioral state within which a person operates in an anxiety-neutral condition, using a limited set of behaviors to deliver a steady level of performance, usually without a sense of risk. [This definition is from: Alasdair White, Comfort Zone to Performance Management, White & Maclean Publishing, 2009]

A comfort zone is a place or mindset where you feel calm. For our discussion, it's the condition in which you believe you have a satisfactory chance to earn a profit, none of your positions is threatened with an immediate loss, and your position size assures that an unexpected and unwelcome market surprise does no serious damage.

Discipline is an important trait for the successful trader

There is no single description that describes the limits of a trader's

comfort zone. My comfort zone and yours are probably very different. In fact, there's a good chance that your comfort zone today will undergo significant changes over the next several years. The disciplined trader remains within the limits of his/her *current* zone and is in no hurry to redefine it. Your trading experiences, how well you maintain discipline and how skilled you are at managing both money and risk, play a large role in establishing the limits of where you feel comfortable.

If earnings fail to meet your goals, then your zone should be tightened, not widened. You have no way of knowing how well you will do over an extended period of time. Please do not become undisciplined and take on more risk because you have a few-month winning streak.

This is your trading career that's under discussion, and it's important that you base big decisions on a sufficient number of data points. Unless you have seen the results yourself, it's difficult to believe that becoming overconfident can ruin a trader. The disciplined trader does not allow a few nice profits to change his/her view of the future. Earning money remains a task that involves an effort on your part. The discipline to remain within your comfort zone is important because failure to do so allows for the possibility of taking a hit.

You cannot know whether you will become more aggressive or more conservative. Don't predict your future performance or strategy selection. Your objective should be to trade, learn, try to figure out why you are making money, and especially important is to determine the reasons why some trades lose money. More on this topic in Chapter 10.

Comfort zones have flexible boundaries. If a specific trade idea is especially attractive, there is no reason why a *small* adjustment to the boundaries is not justified. However, if allowed to become too flexible, then boundaries become mere guidelines. A trader must be able to use common sense and take advantage of special opportunities, but if that trader doubles the size of his/her usual trade, then that's not being flexible, it's being foolhardy.

When you open a position, you anticipate a profit. That's already a comfortable feeling. However, that does not suggest that it's okay to assume the position will remain within your comfort zone.

- If the position turns sour, do not rely on that original feeling

that any developing risk will fade away. A trade with a 90% probability of being profitable can turn into a position with only a 30% chance. And it can happen very quickly.

- When the trade becomes uncomfortable to own, pay attention to the current situation, and not to your feelings when the trade was originated.
- When risk increases, pay attention to the current danger. The conditions under which the trade was initiated are history and no longer applicable.
- Proper risk management requires that you ask: Is the position still within the zone? If it is, then any trade adjustments are optional. But once that trade makes you uncomfortable, you are facing potential losses. Queasiness, uncertainty, fear or any other manifestation that tells you that the zone boundaries have been breached, cannot be ignored.

One of the requirements for trading within your comfort zone is the willingness to accept a loss when that zone is breached. It's almost impossible to become a successful trader if you refuse to accept the premise that every position will not be profitable.

Sometimes you anticipate a loss for a given trade. That does not make it a bad trade. For example, if you believe you will lose two times out of three, but when you win the payoff is five times the original investment, that's a good trade and should fit well within your comfort zone. Over time, on average, for each three similar trades, you lose one unit twice and win 5 units once. That's a gain of 3 units, or a 100% return on your investment.

Thus, whenever the risk/reward profile for the trade meets your requirements, the trade falls within your zone. However, there's much more involved. Position size is critical. You never want to be in position to lose a significant portion of your account value with a single (or even multiple) positions. Each trade must be sized properly to avoid that possibility.

Proper sizing and a trade with an acceptable payout (for the risk involved); that seems sufficient to define a comfort zone. It's your

area, and should be furnished with anything that adds to your comfort.

Emotions

Making decisions based on logic, not emotions, makes it far easier to remain within the zone. In other words, the more you are able to put your emotions aside, the better you can expect to perform as a trader.

Even though it's difficult to accomplish, most traders and investors know that trading without emotion is advantageous, and makes it much more likely than any decisions made during the life of the trade will be well planned and necessary. The chances of making a panic decision are significantly reduced when the trader has the ability to trade without emotion.

That's easier said than done, but there are steps that can be taken to help you achieve this ideal of emotionless trading. As an example, let's use a popular strategy: writing covered calls. If you own stock and decide to collect a cash premium by selling someone else the right to buy your stock at a given price, then you ought to be satisfied if you eventually sell stock at that price.

The truth is that many traders believe they lost money when the stock rises above the strike price of the option. When writing the call, the trader was happy with the trade, and acknowledged the possibility of selling stock at the strike price. Yet, when the stock rallies, that same investor loses sight of the original intention, decides that a larger profit must be earned (NOTE: not 'it may be possible to earn more,' but 'I must earn more') and repurchases the call. Once again the investor is naked long stock, but this time it's at a higher price and a loss has been taken when buying back the call. A position with an almost certain profit has now become risky. Why would anyone do that?

One answer is that the trader is unwilling to accept anything less than the maximum profit available. The covered call trader was about to achieve that result – the maximum possible profit for the covered call position. Sadly, that's not good enough for emotional traders. The possibility – and that's all it is – that the stock will continue higher makes some people buy back that call, increasing both risk and reward potential. If writing a covered call was a good idea in the first place, then buying back that call probably places the position outside the boundaries of the trader's comfort zone. But such thoughts do not occur to the emotional trader.

What's the solution? Never trade covered calls? That is an awkward solution. But I can suggest an alternative. The covered call is equivalent to a cash secured naked put position.

Example

- a) Buy 300 shares of XYZ and sell three Jun 45 calls.
- b) Sell three XYZ Jun 45 puts, with \$13,500 cash available to buy shares if you are assigned an exercise notice.

These two positions are equivalent. [If you are not familiar with equivalent positions, see *The Rookie's Guide to Options*, 2nd edition, Chapter 14, or perform a Google search.] That means each will earn or lose an (almost) identical sum over the lifetime of the trade. The results should be identical, but can vary by a couple of pennies per share when there is a slight inefficiency in the marketplace.

How does selling the put do any good when the profit and loss expectations are identical? For the emotional trader it makes a world of difference. Using our covered call example (a), let's assume the stock runs from its current price to 48. The emotional covered call writer, being unable to accept reality, decides to buy the Jun 45 calls, hold naked XYZ stock, and hope for a price increase. This may be a well thought out decision, but most of the time it is going to be a panic trade. Over the long term, that's not good for the health of the investor's portfolio.

Now look at this scenario from the position of the put seller (b). When the stock moves to 48, the value of the put declines. The higher the stock moves, the more rapidly the put price moves towards zero. The emotional trader sees profits increase as the stock rises. That is as it should be when you own a long position. The difficulty for the emotional covered call writer is that it is not good enough that the overall position is earning a profit. That trader hones in on the fact that the call option is losing money and feels dissatisfied with the position – despite the fact that it is profitable. It may be difficult for this trader to understand that the covered call position consists of both long stock and a short call. In other words it is a hedged position and is working as it was designed to work.

That rising stock price is always psychologically satisfying for the put seller. When you sell a naked option, the best result is achieved when that option's price moves towards zero, allowing you to buy it back at a very low premium, or sometimes, allow it to expire worthless. These are all winning scenarios. There is no urgency for the emotional trader to get upset and there's no rationale for increasing risk.

The positions are equivalent, but the emotional trader may have a much better chance of maintaining discipline – and that means trading without emotions – when short the put, rather than when owning the covered call position.

How much is it worth to trade the equivalent position?

An experienced option trader understands that there are occasions in which a monetary advantage can be found when choosing one of two equivalent positions. It doesn't occur too frequently because markets are efficient and if there is a price aberration, professional arbitrageurs find them quickly and take all the 'free' money that's available. That pushes option prices back into line.

Please understand that the situation mentioned in the above paragraph is not a real money making opportunity for you. Sure there may be a few pennies to be made, but the opportunities are few and don't last long. It's not worth your time to search for them. However, if you spot such a situation, it's right to take advantage.

The question becomes how much extra edge is needed before you take advantage of the opportunity? To me, any edge is worthwhile. But, let's go back to the emotional trader who has trouble handling covered call positions. If you are that trader and find that by writing a covered call you can earn an extra \$5 per 100 shares of stock (after taking all expenses into consideration -- commissions, cost to own the shares and dividends.) when compared with selling the cash-secured put, should you make that money-saving trade? In my opinion, the answer is a resounding 'No.'

The disciplined trader can take advantage of this extra \$5. However, because you know, in advance, that the trade may result in emotional difficulties down the road, ignoring that extra \$5 by considering it to be an insurance policy is worthwhile. Finding yourself in an uncomfortable (when it should be happy because of the profits) position is not worth the extra \$50 on a 10-lot trade.

When you can trade one position as efficiently as its equivalent, then

it makes sense to take that \$5 bill when it is offered.

Other benefits

At times it's not obvious why being comfortable with your positions is important to your success. However, if you recognize that being able to sleep well at night and being less stressed during the day is very beneficial to your health, it becomes clear that the risk you take when trading plays a large role in your happiness and well-being. Also consider your family. It's not fun for them if you are tense with worry. That's even truer when you don't recognize the source of that anxiety.

Maintaining an investment portfolio that falls within your comfort zone helps in more ways than financially. It's truly good for your state of mind and health, as well as for those who are near and dear.

Chapter Four

Money Management

“Hard Work never killed anybody. But why take a chance?” Edgar Bergen

Have you ever heard this commonly offered advice: Sell half the position when the price doubles. By doing that, you remove your money from the investment (or poker game etc.), and can play for ‘free’ using ‘house money’?

It seems to be self evident. You placed money at risk, you removed that money at a later time, and when you hold the remaining half of the investment, or continue to sit at the poker table – using only the profits - you can no longer have a losing trade. The result is that you either break even, or come out ahead by an unknown amount.

What can possibly be wrong with that argument?

The answer is ‘everything.’ It’s a bogus argument.

Let’s say you typically invest \$1,000 in a trade. Let’s also assume that you have unlimited profit potential – perhaps you own some call options. The stock moves favorably and your investment is soon worth \$2,000.

Whose \$2,000 is that? It’s your money. You made an investment, accepted risk, and earned a profit. None of this is house money. It’s yours. Every penny of it is yours. The important factor is that you placed your money at risk. You *earned* those profits. Don’t let anyone tell you it’s not your money. The ‘house’ is trying to take your cash and currently, you have possession of some of what was once their money. But, don’t make the mistake of frittering it away thinking you are taking a free shot. You are investing your own money when you invest your ‘winnings.’

This is how I like to look at any investment. It works for me, so I’m explaining the philosophy for your consideration. Any time you have

the ability to exit a trade, you can walk away with the current price. That means you can lock in that profit (or loss) and accept that as the result for the trade. For stock and options trading, that time is whenever the market is open. For the poker player, it refers to any time there is a game in progress and you have the ability to stand up and leave the table.

If you choose to 'hold' the investment, that's a real decision. It means you wish to continue owning the current trade at current prices. Most investors think there are only two real decisions: buy or sell. That's not true. Electing to hold is the result of making the decision to hold. Because investors choose 'hold' most of the time and buy or sell far less often, they do not consider it to be a decision. The truth is that it's not an 'active' decision. We also so accustomed to holding, that we fail to recognize that not making a trade is an active decision.

That 'doing nothing' is a decision is more readily seen from the perspective of a very short term trader. When you open and close positions within minutes or seconds, then it's obvious that 'hold' is an active part of the decision process.

Sell half the position

It's a good idea to sell half the position, but not so you can play with house money. By now, I hope you agree that it's your money. It's an important risk management technique to maintain a reasonable risk for each position in your portfolio. Option traders may prefer to manage the entire portfolio by paying careful attention to the option Greeks, but the stock investor, or casual option trader, does better to manage each separate trade.

If one of your investments doubles in value, size reduction, back to your standard level – makes sense. There is no reason to have twice the normal sized investment just because it has been profitable. At some point, prudent risk management suggests removing risk from the trade. Sure you can use options to hedge the trade, but for this discussion, I'm trying to keep everything as simple as possible to make one point. By selling half the position and reducing risk, you are taking care of *your* money. Not someone else's money.

It's important for traders to have the correct mindset. Too many feel they can afford to hold a profitable position that's become risky, just

because they have a profit and feel they are playing with someone else's money. If the position is too risky for the potential reward, why own it? When you respect money and protect it, it will remain yours.

This is contrary to the 'let your profits run' investment philosophy. If you choose to adopt that way of thinking about trading, I offer limited objections. You still must use good risk management technique and there must be some point in time at which you reduce risk and pocket some of *your* money. After all, markets can reverse without warning, and gap far lower than any stop loss order you have in place. It's fine to let profits run, but it doesn't have to be 'all' the profits.

One more analogy

If you do a good job at your occupation and earn additional profits or earn a salary increase, do you treat it as company money, or your own money (after taxes)? Investing profits (or lottery winnings or any other cash that legally comes your way) is your money. Treat it with the respect it deserves. If you choose to blow it on an extravagance, that's your choice. Just recognize that it's your money until you spend or use it in some other manner (gift to charity, for example). Those investment profits also represent your money.

Summary

Many investors refuse to take a loss. That makes no sense. If the current mark to the market tells you that the position is worth less than it was when you initiated the trade, you have lost (past tense) money. Don't pretend that holding gives you a chance to get even. It also provides a chance to lose more money. Sure you can hold, but *only* when you want to own the position at its current price. You may even want to add to the trade, but in general, it's a poor idea to add to a losing trade.

If the trade is unsatisfying from either an intellectual or comfort zone point of view, why own it? Close and open a better position – one that you believe has a better chance of earning money going forward. You are trading to make money, and to do that you want to invest in positions you believe have profit potential. If you recover \$500 by holding a losing position, it may give you a feeling of satisfaction, but if you can invest those same dollars in a new position and earn \$1,000 over the same time, how can 'recovering' \$500 from a losing trade be a good result?

Unless you have a good reason to believe that an open position is

more likely to make money than a fresh position, there is no reason not to move your trading dollars into another trade. And that's true whether the position is a winner or loser. It's either good to own or it isn't.

Investors everywhere cling to those losing trades - hoping to avoid a loss, or they gamble with winners, believing it's not their own money. That is ineffective money management.

Chapter Five

I'm Giving Away the Last Nickel. Who wants it?

"The safest way to double your money is to fold it over and put it in your pocket." Kin Hubbard

Two of my basic trading tenets are related:

- When you sell options, or option spreads, it's prudent not to wait for expiration. Let someone else have the last few nickels
- At some point, the remaining profit potential (and that's all it is: potential) is just too small for the risk involved

One of my difficult experiences as a CBOE market maker was suffering through losses that were the result of not buying back my short option positions when they were available at a 'teeny.' A teeny is $1/16$, or \$6.25 per option. Options did not always trade in decimals (decimalization began in 2000), and for many years traded in fractions, with $1/16$ being the smallest fraction.

It seems to be a true waste of money to pay \$6.25 for an option that is 'obviously' worthless. And it is a lot of money. In fact, I used to joke about it on some Friday afternoons when I'd make a point of selling one option at $1/16$, announcing that this was paying for my dinner tonight. [In the late 1970's that price bought a decent dinner.]

Today, I'm horrified that this was my standard operating procedure. When an option reached a 'teeny' it was hopelessly out of the money (or expiration day was near) and it seemed so foolish to buy it back. I clearly remember making a bunch of money when Jan 1978 expiration passed. I was short options that expired worthless. In those days, our account balances (net liquidating value) did not reflect that the options were worthless until Wednesday morning. Today, efficiency and powerful computers make that data available Sunday, or barely one day after the options officially expire on Saturday morning.

Thus, Wednesday after expiration was always a pleasant day. We may have earned the money earlier, but we did not have it to spend until the third business day following expiration. But I digress.

In February, I recognized a powerful income source when I saw one and had an even larger expiration day, collecting those residual teenies. Not only did we not get the value in our account until Wed, but no option was marked at less than 1/8. Thus, that Wednesday 'payday' added \$12.50 per expired option to our accounts.

March was better yet. I decided I was being too conservative and went for a larger payday in April. Alas, April 1978 was not a good time to be short call options. That was my first significant loss.

Getting clobbered should have made it a simple no-brainer to cover those cheap options forever after. But life is not a fairy tale and it didn't happen. I was caught again. More than once.

Today, I no longer play that game. I'm a firm believer in making my profits and letting someone else have the last few nickels on any trade.

Some people prefer to sell options and spreads that are very far out of the money. Yes, the premium collected is small, but those premium sellers believe the profit is guaranteed. It's not. There's always a chance of a major stock market event. Oct 1987 anyone? If you are a seller who collects a \$0.25 premium, then I'm not suggesting that you pay \$0.05 to close. I don't know how to deal with positions that are sold for so little. I know when I sell call or puts spreads at prices near \$1.50, I'm pleased to pay as much as 25 cents to get them back – depending on how much time remains. Today I'm always bidding something to bring those puppies home. A waste of money? Perhaps. But not always. Every once in a while those small buy-backs have saved me a bundle.

This is a difficult lesson to learn. Especially from someone else's experiences. I had risk managers, trading friends, and clearing house presidents tell me how foolish I was. But I knew better. I scoffed, to my everlasting regret. Today, risk management is at the center of my trading and education methods. Near the top of must-do strategies is the idea that there's just too much risk involved to go after the last nickel or dime. I'm happy to allow someone else to earn that profit.

I truly hope that you never suffer through the experience of having

very low priced short positions explode in value. And when I say explode, I'm not thinking that the price may move from \$0.05 to \$1.00. I'm thinking of 10 x that number.

Chapter Six

Profits are in the Future, Not the Past

"It's just paper - all I own is a pickup truck and a little Walmart stock" Sam Walton

Everyone wants to earn money when trading. Most traders keep detailed records, collecting one set of data or another. That's good. Maintaining a detailed trading diary can only help you perform better – depending on which data you collect and how it's used. That's a discussion for another time (Chapter 10).

One of the commonly tracked data points is the result of each trade. Did that trade finish with a gain or a loss? To many, maintaining a high winning percentage is a matter of pride. It's certainly an ego booster to know that you have far more winning trades than losing trades. The problem with running a business – and trading is very much a business, regardless of whether it's full time or part time – based on win/loss percentage, is that you don't pay your bills with a high win/loss ratio. Your bills can only be paid with money.

The true measure of your trading performance is the bottom line: How much money did you earn over a given period of time? You may feel good about earning 5% and winning 70 out of 100 trades, but if I win 40 and lose 60 and increase my account value by 10% over the identical time period, I'm better off. Psychologically feeling good about your trading is important, and it's worthwhile to spend a small number of dollars to gain that psychological edge.

However, I'm interested in my cash earnings and not in my winning ratio. I recommend that you consider following the same path.

Here is one huge problem facing followers of the 'I must avoid taking a loss, and preserve my good win/loss record' trading crowd:

**Holding a losing position –
especially when it is too**

risky to fit within your comfort zone – for the sole reason of having a chance for the market to reverse direction and turn this trade into a winner – is a very costly strategy.

To place this idea in different terms, I know this to me true for me:

The decision on whether to HOLD or CLOSE a position has nothing to do with the original trade. Paying attention to the break-even price leads to unhappy results.

This is a very important point - one that keeps too many traders from being profitable. I hope this is not difficult for you to overcome. But it does require a change in your mindset.

It's a good idea to think about what you are doing when managing a trade. You can manage each losing trade to give you the best chance to make money going forward, or you can elect to manage the trade so that it gives you the best chance to recoup losses. Seldom are these paths identical. The 'recoup' path may involve high risk, but it keeps the position open – giving you the opportunity to recover the loss. The 'best chance to profit' path has you exiting the losing trade, locking in that loss and substituting a position that you (should) prefer to own.

That includes holding onto trades that are most likely going to lose additional money – even after you make a risk-reducing adjustment. The “I must not take a loss crowd’ wants the chance to keep the high win/loss record intact more than it wants to make money. Of course, they don't realize that. I'm sure that trading style is based on the belief that few losses translates into high earnings.

As an alternative, you can manage your portfolio to minimize risk and give yourself the best chance to make the most money when taking an acceptable level of risk. That means trading within your comfort zone.

Simple way of looking at trading

Trading is not a simple business. But my philosophy is based on the following premise:

The trader's goal is to construct and maintain a portfolio that

- Suits that trader's tolerance for risk and fits within the comfort zone
- Has sufficient profit potential for the trade to be worthwhile
- Any trade that no longer meets these minimum requirements must
 - Be adjusted so that it once again meets those requirements
 - Closed. Not all trades should be adjusted
- Gives the trader the best chance to profit going forward
 - Whether it turns out to be a profit based on the original trade no longer matters

If my goal is to make \$1,000, I don't care which specific trade delivers that profit, or if each contributes a small amount. If I earn that money (with acceptable risk), then my objective has been met.

If one of my stocks incurs a loss, it does not 'owe' me. I'm just as happy to make up that loss in a different position. Too many traders feel they must fight a given stock or position to get 'their money back.' It's not their money any longer. It's been lost and the best plan for making money is to own good positions. Sure it can be in the same stock, but if you cannot trade that stock without being hindered by the thought that you are going to get your revenge, you would be better off finding an asset that you can trade without emotion.

Question regarding how to recover a loss

If you learn to trade with logic and without allowing emotions to affect your decisions, you will come to accept reality: The price at which you initiated the trade no longer matters. That price already reflects your trading style, tolerance for risk, your preferred time frame, delta and theta requirements for the trade etc.

The decision to hold, adjust, or exit must be based on the position as it exists now. Does it still fit within your comfort zone? Do you *want* to

own this option position? Do the parameters of the position - right this minute - still work for you?

Look at it another way. Let's say that you were given a cost-free chance to remake your portfolio every morning (with no knowledge about how futures are trading). If you were forced to exit every trade (no commission expenses) and then given the choice:

- Keep the losing trade
- Reestablish the position at the same price, again no commissions or fees

Would you like that opportunity? Would it make it easier to make decisions when you look at each item in your portfolio as a fresh investment idea? You can do it. Not in reality, but every day when you choose to hold your position as is – that is an active decision. It is not passive. You have the ability to exit the trade at any time (the market is open), and failing to do so is an active decision to maintain your holdings.

'Hold' is a decision, despite the fact that most investors believe that 'buy' or 'sell' are the only active decisions. And it's an acceptable decision, unless it's based on the fact that the trade is currently under water and despite the risk of holding, you are not going to get out of the trade. That's not acceptable to me and should not be acceptable to you. Your goal is to make money from today, and to do that you want to own good positions, not those in trouble and in danger of losing even more money.

Chapter 7

Exiting a Trade

"Markets are constantly in a state of uncertainty and flux and money is made by discounting the obvious and betting on the unexpected." George Soros

When to exit is a true dilemma, with no simple answer.

For some traders, psychology plays a big role. That may not sound reasonable, but let's see why I believe this to be true.

Assume you own a position that has not performed as hoped. Recognizing the fact that the risk of continuing to own the position is unacceptable, you exit the trade. You *know* it's the right decision.

Once the position is closed, would you

- Forget about it?
- Watch closely to see what would have happened?

If you chose 'watch it' you are not alone. There is something about human nature that makes us want to be certain that we made a winning decision. Why? It's emotionally satisfying to make the decision that turns out to be the winning choice. By making that correct decision, you are financially better off. And that's your goal when trading. It's always nice to know that you saved yourself from losing even more money by getting rid of the risky position.

The question under discussion is whether that's a good thing to do. It takes time to look up the prices and compare them with the prices when the trade was closed. Although record keeping is an important part of trading, does it really matter if each specific decision was 'correct' from the point of view that it was a profitable decision? Isn't it good enough to know that the position's risk was too much to carry

and that's sufficient reason to exit and reinvest the money elsewhere?

It's obviously important to learn to make good decisions. One way to measure 'good' is to determine the economic outcome of those decisions. If you do that, please recognize that it's going to take a significant number of trades to draw valid conclusions. A few data points can lead to serious misinterpretations.

It's nice to be reassured that you are not in the habit of selling market bottoms and buying tops. The question is whether going back to look at how your decision turned out – provides useful information.

Consider this scenario. The Dow Jones Industrial average is above 14,000 and you own a collection of market neutral positions. The market heads lower. By 12,000 you closed some losing trades and opened new positions. The market continues lower and by 10,000 you closed even more trades. If you decided to take a bearish stance, you are making money. If you chose to have a more market neutral outlook, you probably are not doing well. But each and every one of those positions from which you exited has been a good, profitable (in the sense that losses were minimized) decision.

You continue to initiate new market neutral spreads, but by this time you may have a bullish bias, believing the market cannot go much lower – or you may be trading with the trend, and trading with a bearish bias. Regardless of which applies to you, when the market reaches 8,000 you had additional, no longer market neutral positions to close.

Note that I keep referring to losing trades. Market neutral positions – such as collecting premium when trading iron condors – are prone to lose during big market moves. It's true that some market neutral plays – such as buying straddles and strangles, or owning back spreads can produce profits when the market makes big moves. One problem is that implied volatility was elevated, and buying options at those prices is not an easy task for everyone.

If you had the foresight to adapt to market conditions and decreased position size or perhaps switched to an alternative strategy on a temporary basis, then you may not have been losing during this debacle. This discussion is not meant to apply to each trader's specific results. Instead, it's to define a scenario and attempt to see the role psychology plays when making trade decisions.

Eventually the Dow Jones Industrial Average moves under 7,000 and is approaching the end of its decline. Not knowing that this is the case, you are still opening and closing trades, looking to make money.

At this point, you have exited a bunch of trades and 100% of them have been the correct decision. Unless you adopted a bearish bias or owned a sufficient number of extra put options, you are probably losing money. The good news is that if you exercised good risk management, your losses are far less than those of investors who simply bought and held.

Here's where psychology enters the picture. If you are like most people, you believe you made intelligent decisions, you approve of the methods used to handle risk, and although you may not be happy with losses, you understand that some markets are geared to the iron condor trader and some are not. Some markets work well for bulls and some for bears.

Eventually the market rises. If it moves too rapidly for your portfolio you may again be losing money – this time from being short call spreads and not from being short put spreads. On the other hand, you may have covered all of your short call spreads at very low prices and own a portfolio that contained only put spreads. If you did that (as I did) and can resist the temptation to sell new call spreads on the rally (as I unfortunately did not), then you recovered a substantial portion of your losses.

But, if you see the rally and tell yourself that you should have seen the bottom forming, that you should not have covered, those last few put spreads, and that the idea of being willing to accept a loss when exiting a position is just dumb, then you missed the point. You are 'playing results.' You are ignoring all the money saved on the decline and are focusing on only the most recent trades.

True, those last few exit decisions turned out to be 'non-winners' when looking back at the results. But we cannot see the eventual results when making decisions and must decide based on current market conditions and prices. This is where human nature once again comes into the act. It ignores all those excellent, money-saving decisions made as the market moved from 14,000 to 7,000. It only remembers and focuses on those last few trades, when the market (DJIA) was trading near 6,700.

What does that tell you about 'looking back' to see how your portfolio would have performed had you made a different decision? Nothing useful, in my opinion. On one hand you want to know you made a winning decision. On the other hand, you don't want to be kicking yourself for making a good decision that turns out poorly. Just as each trade cannot be a winner, so too, each adjustment decision cannot be a winner. Your objective is to have the skill to make intelligent

decisions, including exit decisions under pressure. The goal is for those decisions to add cash to the bottom line over time. If you dwell on decisions that turn out to be losers, there is nothing to be learned from the results – unless you discover why the adjustment/exit was a mistake, and what piece of information you neglected to take into consideration.

When examining your trade records, after the fact, there is time to take another look at the conditions and come to a judgment about the quality of the trade decision. If you were truly outside your comfort zone, why second-guess yourself? Perhaps the problem was with position size. When the position is too large, risk avoiding trades must be made more quickly. Don't assume that a losing decision was bad. If the position had been smaller, it may not have been necessary to exit the trade. That places the fault with the initial trade.

Record keeping, coupled with the time to make a careful examination of those records, can be very important to the lifetime earnings of a trader (more in Chapter 10).

Clarification: If you can understand that the trade decision was not appropriate, if you can understand where you made a mistake, then that's truly a worthwhile determination because it will help you avoid that mistake again. The above discussion assumes you made a good decision at the time the decision had to be made. In other words, the decision was based on risk/reward parameters of the trade, your outlook for the market – for the majority who trade with that outlook - and not on emotion.

If you can make good decisions, you will prosper. Don't berate yourself for making a good decision that becomes a money loser. That's my advice, but...

Which is more important?

- Knowing that your financial condition is improved based on your decision making ability when managing risk
- Feeling devastated knowing that you locked in a loss on a trade that would have become profitable, if only you had demonstrated more patience

If you take the logical, unemotional approach, as recommended, you will do better over the long term. However, if the emotional suffering that comes with making a trade that turns out to cost money is so strong that it hinders your ability to function efficiently, then you are

in a true quandary. I'd suggest that feeling this way is not good for any trader and if this describes who you are, then you should not be trading for a living and it may even be better for you to settle for owning index funds and use options to adjust risk, as needed.

Psychology plays a role. You cannot afford to be in situations when a well-reasoned decision may place you in a situation that has two possible outcomes. In the first, the decision turns out to be the winning choice. You smile and pat yourself on the back. In the second, the adjustment turns out not to have been necessary because the market reversed direction. Because this is the situation with which you cannot deal successfully, you get somewhat depressed and know that any forthcoming trade decisions are not going to be made with a clear head.

It's a terrible place to be. If you choose to exit, you risk that feeling of helplessness. If you hold, you have more risk than you can handle. Neither choice is good (yes, you can compromise and cover part of the trade), but just the possibility of feeling crushed may get in the way of prudent risk management. It's not likely you can succeed under these conditions.

The only solution that occurs to me is to adjust more quickly, take less risk, trade less size and do whatever you can to minimize the number of times you are faced with this dilemma. Another possibility is hiring a trading coach. Especially one who understands psychology.

Conclusion

This discussion involves making difficult trade decisions. But it has nothing to do with those decisions. Instead, the discussion revolves around your *reaction* to the results of those decisions.

You recognize that deciding when to exit trades and limit losses is an indispensable quality for the winning trader. Thus, this chapter was written to provide insight on how one trader makes trading decisions and more importantly, how he looks at the results. I prefer not to pay attention to those results. Once the trade has been made and I no longer own the position, I have too many existing positions to spend any time on a position I don't own. Can that philosophy work for you?

Chapter Eight

Holding Positions into Expiration

"Every once in a while you must go to cash, take a break, take a vacation. Don't try to play the market all the time. It can't be done, too tough on the emotions." Jesse Livermore

Buyers

Option buyers understand the pain that the passage of time inflicts upon them. I've always believed that the major goal for all option owners is to sell the option as quickly as feasible. When buying an option, the trader has some objective in mind, and most of the time it's a change in the price of the underlying stock. Less often it may be based on an expectation of an increase in the option's implied volatility. If either of those expectations comes to pass quickly, the option owner stands to profit.

Once that anticipated event occurs, it makes little sense to hold onto the option. You had an idea, it came true, the market responded. Whether the response was better than you planned (good news), or worse (sad news), the event is over, the market has moved, and there is no reason to own the option. As I said, that's my belief.

Many option traders, especially the inexperienced, are often unsatisfied with the economic result (loss, or profit is too small) and hold, looking for the market to validate the original premise. Because the event is over, holding becomes a wager that the news wasn't fully digested the first time, but that it surely will be enough to affect the stock price in the immediate future. Clinging to that hope day after day, the position is held, until it eventually expires worthless. If the option is in the money, all time premium erodes, and the option owner may no longer have a profit.

Holding into expiration is a difficult thing to do, especially as you watch the value of your option decay. What keeps those holders married to their options is the fact that a decent stock move can change the option's value by a large amount in a very short time span. Once the option value has shrunk to almost nothing, it pays to hold in the hopes of a miracle. The problem is that these options should have been sold much earlier.

Sellers

Option sellers are on the other side. The passage of time is most welcome. If the stock doesn't make an unfavorable move, the option – slowly at first, and then more rapidly – loses its value and the market price moves towards zero (for out of the money options) or parity (the option's intrinsic value) for options that are in the money.

This time the question is not when to salvage as much premium as possible, but rather it's when to repurchase the short position to lock in the profit and eliminate risk.

As the price of the option is decreasing, it seems natural to hold onto the short position, at least for just one more day. And that good idea can result in problems. When holding for that one extra day worked so well yesterday, it's natural to anticipate that holding for another day is likely to bring a similar result – an increase in profits. When the option is out of the money in the morning, the probability is that it will remain out of the money when the market closes for the day.

That makes it an attractive proposition to maintain the short position. When a trader thinks that way, there is seldom any incentive to exit. It seems 'obvious' to hold and make more money.

Risk is ignored, with the eye trained squarely on the theoretical time decay for the day. We all recognize that an option with a two delta is going to finish in the money one time out of 50, or approximately once every four years. That's much more frequent than 'never.' With so little to gain, why take the chance? It's important to gauge just how bad it can get, if this position turns on you. The problem for most traders is that they estimate neither the potential loss nor the likelihood of that loss.

When the market has been dull and moving quite slowly, it's even easier to think that way. But just as the option owner gets pretty good gambling odds when holding a soon-to-expire-out-of-the-money option, the trader who is short that same option is taking a big risk (with a high probability of winning) to gain a small amount of money.

I've been there (Chapter 5) and understand the temptation. But the potential loss does not justify taking that risk. Let somebody else have the last \$0.05, \$0.10, or even more for those almost, but not quite 'worthless' options. Yes, pulling the trigger is difficult, but over the longer term, you will be a happier, less stressed trader.

NOTE: I am NOT

recommending that you pay cash to repurchase options that are 10% out of the money when it's two days before expiration. I am referring to placing bids (\$0.15 or \$0.20) to buy options or option spreads when at least three weeks remain before the options expire. I've been able to repurchase spreads @ fifteen cents with as much as seven weeks remaining before expiration. I *know* that's a good deal.

How much to bid depends on your portfolio. If you have sufficient insurance that a major move will not hurt, there is no incentive to bid more than your comfort zone dictates. I maintain insurance, so fifteen or twenty cents is about all I'll bid for one month options. But, when I lack insurance, or when a big market move represents a real financial threat, I bid more.

My top bid, when risk was present was about one penny per trading day remaining before the options expire – with a \$0.35 limit. I did that when markets were more volatile (2008-9). Today, my top bid is \$0.25.

It's your money and your comfort zone, but there should be *some* price – no matter how low – at which it's a good idea to buy back

those ‘cheapies.’ If your commissions are so high that you avoid these trades, you must look into using a less costly broker. Taking extra risk because trading expenses are high does not make sense.

Placing a good ‘til cancelled order with your broker is a good ‘set it and forget it’ routine, but I don’t recommend it. You may forget the order has been entered and that can be a problem. If you work full time and cannot watch the position closely, that’s a different story and I recommend a ‘good for the week’ order that can be reconsidered each weekend.

If you learn to enter an order to purchase those apparently worthless options, ask yourself: Which would make you feel worse

- Not exiting when you know you should, and occasionally losing real money?
- Exiting and seeing the options expire worthless

It’s that psychological factor at play again. If you know taking a specific action could induce feelings that hinder your ability to function efficiently, then for peace of mind, avoid the choice that could result in those feelings. Remember, if you simply learn to ignore what happens after you exit a trade, there is no danger that this will occur.

Hold or exit

As expiration approaches and you are facing a ‘hold ‘em’ or ‘fold ‘em’ decision, I recommend making the best decision, with everything being taken into consideration. If holding and losing extra money represents an unhappy outcome, but folding, only to see the market ‘behave’ would be so upsetting as to hinder your trading, you would be in the bad position of being forced to take extra risk – just to avoid that ‘devastated’ feeling. Advice: consider making adjustments by reducing position size. By the time it becomes necessary to exit, the position may be small enough that exiting at the market top (or bottom) won’t feel so bad.

Obviously it’s best not to be hurt by losing decisions, but the truth is

that every trader cannot do that.

Trading involves much decision-making. Do the best you can (sure, try to develop skills that allow you to make even better decisions), but learning to live with those decisions is a skill worth developing.

Chapter Nine

Strategy Selection vs. Risk Management

"A billion here, a billion there, and pretty soon you're talking about real money." Everett McKinley Dirksen

Let's begin with the bottom line:

When I talk to anyone about the concept of choosing an option strategy (or two) to adopt for trading, I stress that the strategy should have certain characteristics. First, it must be understood completely. It may sound trivial, but the trader must know how the strategy works and what must happen to the underlying stock for the trade to make or lose money.

Second, the trader must have confidence that this strategy is appropriate for his/her personality and comfort zone. For example, selling naked straddles (one call and one put, same stock, strike, and expiration) is a higher risk strategy that will appeal only to the most aggressive investor (and it's likely your broker will not allow you to adopt that strategy). Even iron condor traders cannot just adopt that method in the dark. Strikes chosen and expiration dates play a big part in determining whether the specific trade is acceptable to the individual.

To trade options, it's obvious that you must begin by buying and/or selling options. The combination of options – whether it's a single option or a combination of several different series -- defines the strategy. [A series defines a specific option. All IBM Nov 130 calls represent ones series. Any other IBM option, including the Nov 130 put, is not part of that series.]

Thus, to play the game, you must adopt a position. Thus the strategy is your ticket. It's your entry onto the playing field. It's important to be comfortable with the choice, but it is not the only significant factor in your success (or failure). Risk management is more important (in my opinion). If you lose too much at one time, it's going to hurt your long-term results. Be careful and don't allow losses to overwhelm profits.

Selecting one or two preferred option strategies for trading is important because it gives you confidence that your methods can produce profits. There is no point in trading strategies that are recommended to you when you are uncomfortable with any aspect of that strategy. One simple example is the sale of cash-secured naked puts vs. selling put spreads. The former allows for larger profits but involves much more risk. The former is a reasonable play for investors who want to accumulate shares of stock on market declines. If you don't care to buy stock and especially if you prefer limited risk strategies, you are not going to be comfortable selling naked puts. If you adopt one of these methods for trading, it's not that one method is vastly better than the other that should affect which you choose. Instead, it's which is more compatible with your comfort zone and tolerance for risk. If someone makes good money with a specific strategy, please don't believe that that strategy makes a good choice for you. Sure, consider that idea, but don't adopt it just because it works for someone else.

Whichever strategies you decide to trade, your long-term results are going to rely more upon your ability to manage risk than upon which strategy you use.

Many traders don't recognize the importance of

risk management until it's too late. By the time they understand that preventing losses is the name of the game, their trading account has been wiped out.

Options were designed to reduce risk. It's unfortunate that far too many rookies begin using options as tools for speculating in the stock market. And it's not only beginners. There's something appealing about using options as a mini-lottery ticket that attracts the attention of all traders. Some can resist, some cannot. As with real lotteries, the odds of success are against the investor who buys a handful of inexpensive, out of the money options, with the expectation that a miracle is at hand. An occasional win keeps them playing. That's the way a slot machine takes your money. You lose money, make a partial recovery, and continue to play until the money is gone. To repeat: options were invented as risk-reducing tools. They are designed to shift the risk to someone who is paid a premium to accept that risk. There's no need to minimize risk to the point that profits become unlikely, but there's also no reason to make long shot plays with little chance of success.

Options are unique in the investment world

Options have specific risks that can be measured. Think about that. When you buy stock, your risk is simply that the stock can move lower, resulting in a monetary loss. But when you own a position that consists of options instead of shares, risk can be identified, quantified, and hedged. That's the subtle beauty of trading with options. *When you adopt a specific strategy and make trades to implement that strategy, what you have really done is make an investment whose risk can be managed.* When you own stocks the only way to manage risk is to sell some shares.

By understanding the risks, you have the ability to keep them under control. It may feel 'more risky' to have a position with specified risk factors – but the truth is that those factors can be reduced by taking appropriate actions - and that makes option trading different and far more effective than buying and selling stock.

What do those Greeks measure? Time decay (theta), exposure to a change in the market volatility (vega), being too long or too short (delta, or share equivalence). If you are familiar with [the Greeks](#) then these risk factors are already known to you. The Greeks go further. They not only measure the rate at which certain risk factors affect the value of your position, but they also measures the rate at which those

factors change (gamma, for example, measures the rate at which delta changes).

Taking the time to understand the Greeks is important, but I consider Greeks to have only one task. They allow you to quantify risk. How much can you expect to earn or lose if the underlying asset moves to this price or if the implied volatility changes by a 10%? Once you quantify risk, the decision becomes: Is that risk acceptable or do you want to hedge (reduce it)? That's what makes options *special*.

If you don't pay attention to managing risk, then you sacrifice the key factor that separates options from all other investments.

Most traders consider choosing a specific option strategy as the key to profitability. They speak of iron condors or selling naked puts as if those words can manufacture profits out of thin air. Only the more experienced trader understands that preventing losses and managing risk is more important.

Most reasonable strategies can produce good results - but market conditions must be appropriate. No one is going to suggest that selling naked puts works in a strong bear market, but if managed well, it can be a winning strategy for investors who like the idea of accumulating stocks whenever the market declines. I no longer sell naked puts, but at one time it represented a good portion of my trading.

Traders argue the merits of their favorite strategy. Which is most efficient for you to trade depends on many factors, including your personality and the effect of psychological factors. For example, see the discussion in Chapter 3 on covered calls vs. an equivalent method, put selling.

Your job, as risk manager for your portfolio, is to prevent those large losses from occurring. Your partner, the trader portion of your persona will try to convince you to relax your restrictions on how much risk should be allowed. Don't give in. It's okay to be a bit flexible on occasion, but you must make the final decision regarding risk. Too many traders lose sight of their long term goals when caught up in the excitement of the moment. Maintain your composure and your partnership will be everlasting and fruitful.

Bottom line: Choose a trading strategy that makes you comfortable, but manage risk carefully.

Choosing the 'best' strategy is not your objective.

- The strategy – by itself -- does not make money

- The strategy is merely your method of playing the game
- The strategy tells you which options to buy and sell

Risk Management tells traders

- How many options to buy and sell (position size)
- When to buy and sell them
- When to take profits
- When to adjust or exit the trade

In other words, risk management tells you how and when to control risk to help manage money and prevent large losses

Chapter Ten

Trading Plan and Record Keeping

“Never invest in a business you cannot understand.” Warren Buffett

Successful traders keep good records, including a trade diary and a trading plan. It requires a great deal of work to do the job properly, and it's easy to decide not to be bothered. I understand because I didn't want to take the time.

You can get by without a plan, but I don't believe that's a good idea. You can be more focused on your positions when you have a written record of your thoughts at the time the trade was initiated. Those thoughts include your intended actions as the trade matures and can help you through difficult decisions because they were compiled under ideal conditions, with no stress.

The plan must include your initial profit goal. Sure, that goal can change as market conditions change and as time passes, but that goal gives you a planned exit point. That's always helpful when it's time to pull the trigger.

Contingency plans were written in stone, but it takes a solid reason to make changes. It's worthwhile to reread those initial plans and always be aware of them. Add new thoughts as time passes. If all goes smoothly and your predetermined closing point is at hand, it's reasonable to *re-evaluate* the original plan. It's not reasonable to change that plan just because 'things are going so well, that I'll try to earn more money.' That would be an emotional decision. If you have a solid, logical rationale, original plans can be altered.

More importantly, your plan requires that you think ahead and decide at which point the trade is obviously not working as intended. Perhaps you bought options and the stock price is stagnant. Perhaps you traded an iron condor and the stock is moving too quickly. It doesn't matter. Your plan must include a good estimate of the price point at which you would declare the original premise is no longer viable and

it's time to exit or make an adjustment. When writing the plan, if possible, take notes with suggestions for possible adjustment trades.

When trading options rather than stocks, time remaining prior to expiration plays a big role in the details of your plan. If enough time passes (and you have positive theta), your initial plan may – and probably should – undergo a *minor* alteration. The point is that having a plan can save you a lot of time and stress. If the adjustment point arrives unexpectedly (a gap opening, for example), having a plan in place would allow you to make a quick adjustment without having to take time to consider a bunch of alternatives.

To a student of technical analysis, a breakout or breakdown is an excellent reason for abandoning (or adding to) an existing position. There should be little hesitation because you know that a trade adjustment is necessary.

Because everyone doesn't use technical analysis, this type of decision is not always so simple. But if you know that being short 300 (or any other number) of deltas is just too many, and if you know that your plan calls for adjusting to delta neutral, the decision becomes much easier. The only choice is which specific options to trade. Some traders prefer to adjust with shares of the underlying asset, but I'm not one of them. I prefer to adjust by buying positive gamma to reduce future risk. That's not for everyone because it involves negative theta. I don't believe neutralizing delta is good enough because there is no reason to ignore all the other Greeks.

You make the needed adjustment or perhaps as an alternative, exit the trade. But you do not have to incur stress over the decision. You made an intelligent plan when you were not stressed, at a time when no money had yet been lost, and at a moment when no emotions were in play. In other words, it was a sound decision, and the best approach is probably to follow that plan.

As mentioned, a good plan is flexible. If the plan calls for buying vega-rich options and implied volatility has risen considerably since the plan was devised, it may be better to consider an alternative, rather than pay up for an adjustment. That's the reason for including more than one possible trade in the plan.

Note that the word is flexible, not breakable. Minor adjustments should be acceptable, but only if you have sufficient discipline to know when enough is enough.

Once that adjustment is made, it's a good idea to update your trading plan – both in terms of how much profit you are seeking to earn (from this point forward) and conditions under which you plan to make the next adjustment.

Diary

As part of the plan, keep a diary of trades and thoughts. If you are considering adjusting early, the thought process may be helpful the next time you face a similar decision. And that's just as true if you elect not to make the adjustment. When considering a change to the original plan, the rationale and final decision is important to record.

The diary must also include the results of the trade and an analysis of the efficiency of your original plan, the benefit (or lack thereof) of altering the plan, and any other data you believe is relevant.

At some point, there will be an extensive record of your thoughts and actions. Maintaining records for later review allows you to take another look at your trades, and perhaps discover that one trade type led to higher profits than another. Better yet, you may be able to discover something special about trades that were less successful. If you figure out what separates the winners from the losers, then you can eliminate certain trades from your repertoire.

I don't expect this to be easy, such as iron condors were great but calendars spreads were money losers. The discovery is going to be much more subtle than that – something that you would not be able to discover without such careful record keeping.

Example: For the sake of discussion, let's assume 65% of your trades are winners. Let's also assume you have many data points – perhaps 100 opened and closed trades - 65 winners and 35 losers.

a) If 20 of those losses came from trades opened immediately *after* closing a different trade at a loss, it may be that you were too anxious to make a new trade. There may be a subconscious effort to quickly recover the lost money. In this scenario, you would be extra careful – or perhaps extra conservative - when entering into a new trade after exiting a loser.

b) Examine any large losses and determine whether you stubbornly held onto a bad

position, or whether you were truly unlucky. If you can find hard evidence that you were stubborn, that may be all the evidence you need to convince yourself that being stubborn is a bad idea.

c) If you had a few winning streaks – maybe 5 or 6 consecutive wins, it would be a good idea to take a look at the losing trade that broke the streak. Maybe these trades have something in common. Too aggressive? Too near the border of the comfort zone when initiated? Were you too slow to adjust believing that all your trades should be winners?

Similarly, it may pay to take a closer look at the last winning trade of a winning streak. Maybe there was something special about those trades. You would be looking for the proverbial needle in a haystack, but it's worth the effort.

There is no way to know if you will discover worthwhile information, but anything that gives you an edge – and not making trades in situations for which your losing percentage is higher than average – is definitely to your advantage.

Understand that the above advice does not suggest that you cook the books by attempting to have the outcome you want for your records. On the contrary, making the best decisions possible, and ignoring whether the trade is profitable provides real data that can be analyzed at a later time. Do not let the fact that you are keeping score affect your decisions.

Trade first, analyze the data later - but only when there is enough data to draw meaningful conclusions.

You know a risky, uncomfortable position when you see it. And when you see it is the proper time to do something intelligent that reduces risk.

Remember that the trading plan not only suggests where to seek your profits, but it also tells you when trades must be fixed to limit losses.

Work? Yes, it's work. But if trading is your full time job, there is no excuse not to keep records that serve one purpose – helping you to do your job better, and that means to increase your profitability. When striving to improve your methods, the ability to devise plans and pull

the trigger on trades is essential – if you want to achieve exceptional results.

For non-professional traders, it's more difficult to spend the necessary time. Record keeping, and how detailed those records should be, is a decision that can be dictated by your comfort zone.

Chapter Eleven

Trade Decisions

“A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain.” Robert Frost

Make the best decision you can at the time the decision must be made. Do not berate yourself if it turns out not to be the winning decision.

This is a constant theme in my writing. If you trade, you must pull the trigger and enter an order. Fail to do that and you have no position, no risk, and no chance to earn a profit. The same applies when it's time to make an adjustment, reduce position size, or exit. You make a decision based on the information available, your trading plan, your comfort zone, etc.

If you planned well, these decisions will be well reasoned, with no emotions getting in the way, and certainly not the result of panic. If you have a trading plan (Chapter 10), your decision has probably already been made, and all you need is the will to execute the trade.

Once the trade has been executed, it's part of your portfolio. Your time and energy are best spent analyzing the position you now own, and not the position you owned earlier.

With a modified position, it's time to go back to your trading plan and consider alternatives for the next possible problem spot. If you acted according to your plan, you probably gained confidence in the idea of having that plan in place.

Results

Regardless of how well you executed the trade, it's important to recognize that you did the best you were able to do under the circumstances. Accept that fact and move on.

If you come to the conclusion that you made the wrong trade – not

because it's losing money – but because you discovered an alternative that you had not previously considered, you are well placed to take advantage of the new discovery. First, you are allowed to re-adjust the position into something better. More than that, you uncovered a piece of information that can be used again when you prepare additional trading plans for future trades.

There's a clear distinction to be made: Accepting the fact that you did your best at the time, does not require you to steadfastly remain married to the new position.

- If you see the chance to make an additional adjustment that improves the quality of the position, then do it
- If you believe you made a mistake when exiting a position, you may reopen it. Just keep in mind that to qualify for being reestablished as part of your portfolio, it must be the *best trade* available now. Do not reopen the closed trade when the primary purpose is to recover a loss. The position must merit inclusion in your portfolio on its own.
- New positions are established because they represent the best trade you can find that meets your risk/reward requirements, and fits snugly within your comfort zone.

Chapter Twelve

You Have a Loss? Don't Allow That to Influence Your Decisions

“I figure you have the same chance of winning the lottery whether you play or not.” Fran Lebowitz

One principle that guides my trading is that the only price that matters is the current market price. If you believe the market is evaluating a specific position incorrectly, you can take advantage of your opinion by making a new trade. You can buy if you believe the market undervalues the position or you can sell when you feel it's priced too high.

What you cannot do is argue with the market. The 'market' doesn't want to hear your opinion. The market is giving information to you – information that is ignored at your own risk.

I'm specifically referring to a position that you own. At some time in the past – perhaps earlier today, or a week ago – the time is irrelevant – you made a trade and own a position. If you want to close the trade, you have a choice. You may accept the current market price or wait, looking for a better price.

Clarification: DO NOT enter a market order to exit the trade. Always use limit orders. The point I am making is that the current bid/ask quotes tell you the approximate price at which you can trade. You definitely want to obtain a better price than the market makers are asking, and it's correct to aim for a fill near the midpoint of the bid and ask quotes. But if you want to collect \$4 and the current market requires you to pay a \$2 debit, there is no chance to get filled. You may be able to exit by paying \$1.70 debit, but a \$4 credit is not currently possible. That's what I mean when I say the current market price is the price that matters. You pay (near) that price, or you hold. Your price is not available at the present time.

You have a loss?

No one (except for you) cares whether the current price represents a

profit or loss. You should not care either. I know that is heresy to some traders. I am NOT telling you to ignore profits and losses. But, under certain conditions, profit and loss considerations distort the picture and lead you astray.

If you own a comfortable position and are looking for an exit point, you have the luxury of taking all factors into consideration. But, when you own a position that makes you uncomfortable and has either moved beyond the boundaries of your comfort zone – or is threatening to do so – you have less time to worry about profits and losses that already occurred. Your focus must be on profits and losses that may occur in the immediate future.

If a position is too risky to hold, it's vital that you make an intelligent decision. For me, the process works this way:

a) It is okay to adjust, if that adjusted position reduces risk and the newly adjusted position offers a good chance to earn a profit – from today, not from the original point of entry. In addition, the position must have an *acceptable risk*. Note: The chance to recover the loss is not the important consideration. The probability of losing more money from a position takes priority. Protecting your remaining assets is far more important than attempting to recover lost assets.

If an adjustment results in a position that meets your needs and fits within the limits of your comfort zone, then it's a suitable trade. If it's a piecemeal adjustment that gives you a chance to recover, but which makes it likely that additional losses will accrue, then it's a poor decision. Protect your remaining assets and do not place priority on recovering losses. The best way to recover losses is to open *new* positions that earn profits. It is not working with risky positions.

b) It is acceptable to exit the trade. That decision must be based on current risk/reward attributes of the position. Sure, you can add your market outlook into the mix, but unless you have a proven track record of being able to

predict the market (and finding yourself in the current troublesome situation suggests otherwise), don't count too heavily on that outlook.

The point to be made is that far too many investors continue to take unacceptable risk for a single reason: Exiting at the current price locks in a loss. Those investors would rather face the high probability of additional losses, rather than accept the fact that a trade lost money. Does that make sense to you? Holding a trade because closing would lock in a loss? Holding a risky position because you want to recover a loss? It makes no sense to me. I understand that it's not easy to walk away from a trade.

If you learn to make trading decisions by ignoring the original price paid for the trade and managing the position based on current risk, you will perform better over the long term. You will not hold risky trades with the hope of becoming lucky. You will own positions that are comfortable to own and which have good risk/reward parameters.

This mindset is not easy to accomplish, but it is worth the effort. Note, elsewhere (Chapter 10) I discuss the importance of maintaining careful records of your trades and thoughts. This is not a contradiction.

Summary

Here is something I believe very strongly, but I accept that it's difficult to convince others: The original price of the trade no longer matters. The only things that need concern you now are:

- You own the position at the current price.
- Do you want to continue to own the position at this price?
- Do you accept the risk/reward of the position as it stands NOW?
- Whether the trade is currently profitable is immaterial.
- You cannot profit on every trade.

Your job is to manage risk, not worry about being profitable on each trade. If you ignore risk, luck will play a big role in your profitability.

Have a serious talk with the portion of your persona who represents your risk manager. He/she must be given more authority over the trader.

This general concept is continued in the next chapter.

Chapter Thirteen

Getting Even

“An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today.” Laurence J Peter

Most investors tend to trade from the long side. They have been trained into believing that owning stocks and/or mutual funds is the right and intelligent thing to do. I'm not going to argue with that premise. After all, everyone loves a bull market; everyone thinks a bull market is good for the country and the world.

When equity markets are rising, many people have more assets, feel wealthier and spend more. Businesses expand and jobs are created. That leads to a growing economy, full employment, and maybe even rising home values. Everyone is happy. When average citizens live within their means and avoid believing that the good times will never end, prosperity is good. But, as we have seen, when people live beyond their means and accept excessive debt, the world can come crashing down upon them.

However, it's not prudent to fail to recognize that markets do decline on occasion. And then they recover. Or at least that's the assumption being made by most people who are never prepared for a bear market. Most investors who lose more than they can afford during those declining markets hold on, hoping to achieve nirvana. In this case that means getting back to even, which is defined as the maximum value of the portfolio prior to the market decline. Getting back to even is the target for most investors. What's not included is any mention of what the investor plans to do if and when he/she does recover and their accounts are back to pre-bear market levels. Get out of the market and stay out? Diversify assets so that there is less dependence on the stock market? Not a chance. By the time the investor's assets reach top dollar again, the worry is forgotten, the good times are remembered, and the investor is back to being his/her old bullish self.

Even the government gets involved in attempting to maintain higher stock prices. Legislators, having no idea about the value that short

sellers play in keeping the game honest, pass laws that make it more difficult to sell stock short. Some feel the need to blame bear markets on short sellers and never on the executives who destroy a business by their awful business decisions. One example occurred within banks. The bank's traders made so much money that they overpowered the bankers, and convinced them to continue taking monster risk to earn monster profits. In fact, they probably went farther and hid the amount of risk that is required to earn such large profits. It didn't take much convincing. Those profits made bankers ignore what the banking business is all about.

Alas, it doesn't always work. Not all traders who work for the banks make a fortune. One rogue trader was able to destroy Barings Bank all by himself. [In 1995, Nick Leeson's ever-increasing speculative bets in the Asian stock markets lost so much money that it destroyed the bank.] It had been The United Kingdom's oldest investment bank before his unauthorized trades resulted in losses than could not be covered. The original large losses were not the death knell for the bank. It was the attempt to get back to even – the attempt to hide losses that soon overwhelmed the original losses.

Guidelines for success as a trader. Don't try to get even

- 1) To succeed over the longer-term, losses must be minimized. Thus, risk management is an essential skill for any trader
- 2) Your trading/investing goal is to make money. Your plan is to trade so that your account value grows month after month
- 3) It does not matter from which specific stocks you earn your profits
- 4) No specific stock 'owes' you a profit. If you lost money the last time you traded that stock, it doesn't mean you should force a borderline trade in an attempt to 'get even'
- 5) If you have a losing position that has moved outside your comfort zone (too much risk going forward):

a) Do not increase your position size in an attempt to get even

b) Do not hold, hoping the stock will reverse direction, allowing you to get even

c) Do not alter (adjust) the position because you refuse to accept a loss

i. Adjust the position ONLY if you still want to own a position in this specific stock (or index) – and if this new position exceeds your requirements for making a trade

ii. Adjust the position so that both risk and reward potential are acceptable. That refers to potential risk/reward for the future. What's lost is lost. Don't dwell on it. If you cannot find a position you want to own, then exit this trade and find another

6) If you believe that one stock offers a good trading opportunity, then that's the place to invest your money. Get out of the risky position and move to one that is more likely to earn money in the future and is more comfortable to hold.

This is a difficult concept for some people to grasp. After all, money has been lost and the investor wants it back. It's difficult to see that it doesn't matter where those earnings originate. Sure, it's nice to get it back from the trade that took your money. But it makes no difference which trade provides those profits. That's why you want to be invested in positions that meet your needs, fit within your comfort zone, and are likely to produce that profit. Holding onto a bad trade makes no sense.

And it's even more difficult to take the necessary action to accomplish this objective. Being human, emotions play a significant role in our trade decisions, despite all efforts to put them aside. The 'need' to recover losses from one specific stock blinds many to finding an opportunity to make money from another stock.

Another [blogger](#) (Jeff White at The Stock Bandit) agrees:

“You might be struggling in this market right now (June 2008), and if so, remember that there are a couple of things you can do. First, stop trading. Close out your losing positions and clear your head for a little while. It'll be well worth it, both monetarily and mentally. Second, regain your focus. Remind yourself what you're aiming to do with your trading, what your style consists of, and what you need to see before taking new trades. If you don't see it, don't push any buttons! And finally, don't try to “get it back” quickly. That is the fastest way to compound your problem and double or triple the size of the hole you find yourself in.”

Chapter Fourteen

More on Comfort Zones

"I had a dollar. I had a friend. I gave my dollar to my friend. Now I have no dollar and have no friend." unknown

Throughout this book I've written about the advisability of trading within your comfort zone. Let's take a closer look at how that zone is identified. In [Chapter 3](#), I offered a technical definition of 'comfort zone.'

When making a trade that initiates a new position, most investors concentrate on the importance of the profit, or how much can be earned from the trade. Despite the fact that it hinders their long-term profitability, most traders take it for granted that the sole purpose of making the trade is to earn that profit. As was mentioned in Chapter 3, it's possible to make a good trade when you expect to lose money. That occurs when the *payoff* is so attractive that it overwhelms the less than 50% chance of being profitable. The importance of risk management is lost in the euphoria of finding a trade that will probably earn a profit.

Those who understand the importance of managing risk also know the answer to the questions: how much money can be lost and how much risk is required to earn that profit? When you are satisfied with both the reward potential and possible loss for a given position, then you are within your comfort zone. In other words, that's when you found a trade worth adding to your portfolio.

There is more to a trade than the entry point. As time passes and markets move, the

characteristics of your position change. It's important to remain within your comfort zone at all times. This is the point that many traders fail to see. They mistakenly believe that if the position meets their requirements when opened, nothing else has to be done until the options expire.

The rationale behind not paying careful attention to risk may be a thought process similar to this one: 'The position has a limited loss. Even though that maximum loss may be larger than I want to accept, it is limited. Thus, I can just allow time to work its magic, and if I'm not too unlucky, I'll have a nice profit when expiration arrives. In other words, the philosophy is: I made my bed, now I'll lay on it.'

I cannot accept that. Risk may be limited, but there is no reason not to take active steps to give you the best chance of minimizing any loss, or better yet, turning it into a profit. To blindly accept what happens is the definition of gambling. Trading and investing are interactive pursuits. You are not wagering on a horse race. You can and should take action, as needed, to improve the probability of having a successful outcome.

'Good' trades can turn bad. Low risk propositions can become riskier. On the other hand, good trades may work so well and so quickly that it pays to exit and take a fast profit, rather than hold out for the slightly larger profit that you originally sought. Why? When dealing with positions with limited profit potential, risk can suddenly become unfavorable compared with reward, when there is not much additional profit to be earned. If the stock makes an unexpected move, the profit can easily disappear. Take your profits when there is little to gain by holding.

When the underlying stock makes an

unfavorable move and another such move would result in a substantial loss, that additional risk probably moves the position outside the limits of your zone. When that potential loss has increased to an unacceptable level, the risk of holding (and hoping the stock reverses direction) is too great. Closing (or otherwise adjusting) the position is necessary to move the position back into the zone.

Comfort zone boundaries can be flexible to accommodate special situations. That does not suggest that every troubled position should be ignored, allowing you to prove to yourself that you are a flexible trader. If you lack the discipline to make adjustments and/or take losses, then you require strict limits on losses. Flexibility is reserved for traders who have proven they can handle the difficult decisions under stressful circumstances.

As you gain more trading experience, redefine the boundaries of your comfort zone. Don't take more risk to demonstrate you can handle it. But, it's appropriate to change your basic methods as market conditions change, as you become a more experienced and confident trader, and as the size of your trading account grows. Don't make quantum leaps. Make gradual changes, especially in deciding how much size to trade. If you are comfortable with 10-lot positions, a reasonable increase is to trade 12 to 15 contracts before attempting to move to 20. And do not move from 10 to 50. That will place too much stress on you, and lead to unfavorable results

For example, bullish strategies such as writing covered calls may make you uncomfortable (for good reason) when the market is bearish and you may prefer to trade iron condors instead. Or you may decide to adopt bearish strategies to play with the current trend. This is where flexibility is important.

If and when your market outlook becomes less bearish, you can switch back to writing covered calls, or better yet, trade with the added safety that comes from selling put spreads. That's why it's a good idea to be aware of alternative strategies, even when you have no immediate intention of adopting them. They become part of your arsenal of useful trading tools.

- Dr. Brett Steenbarger, whose expertise is trading psychology, makes this point very well in his [TraderFeed blog](#): "It's difficult to succeed at trading, but – given rapidly changing market

conditions – even more difficult to sustain success. It's not good enough to find winning trading techniques; one has to continually adapt these techniques to an ever-changing environment.”

Chapter Fifteen

Odds and Ends

"Money isn't everything, but it's right up there with oxygen." unknown

My special area of interest involves working with those who are new to options. Previously I shared some of my thoughts about trading and my philosophy – ideas that are directed to rookies. As an example, these two ideas work well together.

- Don't trade with real money before you are prepared. Trading is not a game
- You have the rest of your lifetime to trade options. Demonstrate some patience

Many investors come to the options world in an effort to learn how options work and to decide for themselves whether using options to reduce risk would help them meet their investment objectives. For those investors, continuing their financial education by learning about options is simply the next natural step.

Such investors generally are well grounded and understand the rationale behind being prepared before using real money.

However, there is so much Internet hype about options, and how they can be used to make a fortune – quickly – that some neophytes must be warned. It's easy to get excited about trading options when a friend tells you that he recently turned \$200 into \$2,000 in one week. It's probably true that the 'friend' had many failures before achieving that success, but that story is enough to make some people lose their common sense. Greed is indeed a powerful force.

To those investors, I direct this message. Don't fall for the hype. You will not earn 10% every month for the rest of your life. You may be able to earn good profits, but first comes the work, then comes the trading. If you are disciplined and understand what you are doing,

then profits can be earned. I'm referring to reasonable profits. Even thinking about 10% per month can be harmful.

No one is giving away money. If you trade options, your profits must be earned. Earnings represent income that comes from work. Work and effort.

True, you can gamble, and like your friend, achieve an occasional big win, however, that is not the path to long-term profitability.

Educate yourself. Read books and blogs; ask questions; attend free webinars; take lessons from credible institutions via the Internet. I suggest both the [Chicago Board Options Exchange](#) and the [Options Industry Council](#).

Another pair of my basic beliefs about options work well together. These are directed to all traders, and not merely to rookies:

- It's easy to make money with the option strategies I recommend
- The difficult part is keeping those profits

There are many option strategies and various ways to approach each. Over the past few years, I've been trading iron condors, but I don't recommend that specific strategy over others. It happens to suit my needs.

The point for discussion here is that I can choose among a variety of specific strike prices to build my position. If I wanted to win very often, the profits would be modest. I can choose spreads that give me a 95% chance of being profitable each time I open a new trade. That sounds wonderful. It's easy to make money. Month after month. But the profits are small when the probability is so high. Let's assume you can earn \$30 per month when \$1,000 is at risk. Nineteen wins is \$570. That does represent an impressive 57% return (ignoring the possibility of compounding profits) in just over a year and a half. That's an outstanding result, by anyone's standards.

The problem is the other 5%. Most people look at a 95% probability as if it were a near certainty and never consider the whole picture. That whole picture includes one loss for each 19 wins. It's certainly possible that the loss will be small – perhaps \$50. But it's also possible that the entire \$970 can be lost. [\$1,000 is at risk. But you collected

\$30 to open the trade, limiting losses to \$970.] And even if you don't lose the maximum every time you lose, on average this is not a good game. The chances of collecting a satisfactory income are poor over the long term.

Despite that fact, many people enjoy the easy money on a regular basis and assume they will be able to protect themselves from any disaster.

Reality paints a different picture. In attempting to prevent a disaster, it's sometimes necessary to take defensive action. When it's time to make an adjustment or exit the trade, you no longer win 19 times out of 20. There are no big losses, but there's more than one loss. If your win total is reduced to 17 out of 20, and if the three losses are only \$150 each, the net profit (over 20 months of trading) is merely \$60. That's not enough to cover trading expenses. That cannot be worth the effort, let alone the risk.

Bottom line: You can easily find ways to have a large percentage of winning trades. But, that's just not good enough. The wins must be large enough to compensate for the times when you lose. It's easy to make money with options. But unless you adopt a strategy where the risk/reward is favorable and you are willing to take that occasional loss to protect your assets, you will discover that it's also very easy to lose money when trading options.

Afterword

I've learned many lessons in my trading lifetime, and that represents half the time I have been alive. The most important lessons involve risk management and the importance of protecting your assets.

I've also developed my own philosophy of trading. Some of the tenets I hold to be true are shared by most traders. However, some of my ideas are significantly outside the mainstream, and that's the reason I put together *Lessons of a Lifetime*.

I wanted to share my thoughts in one place, instead of seeing them scattered throughout my work. My goal is to have readers consider different ways of thinking and then deciding for yourselves which, if any, of these ideas work well with your own attitudes about trading.

Please keep one point in mind at all times: A trader has different objectives than an investor. An investor may be able to outperform the market averages, but the more likely result is to underperform.

But a trader is different. The average trader loses money and in fact, the average outcome for a trader is to lose his/her entire trading account. If you are a profitable trader, you are already better than average. Give serious thought to the danger of taking more risk in an effort to become a more profitable trader.

I've enjoyed sharing my trading style and thoughts with you and I hope the journey was educational and that you had an interesting ride.

Thank you for buying Lessons of a Lifetime

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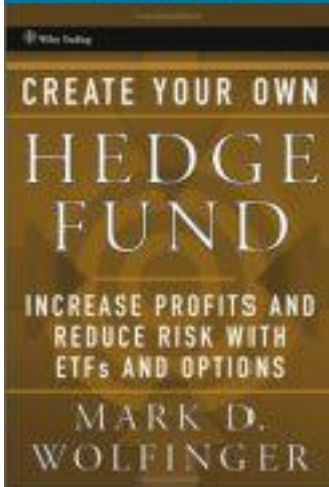
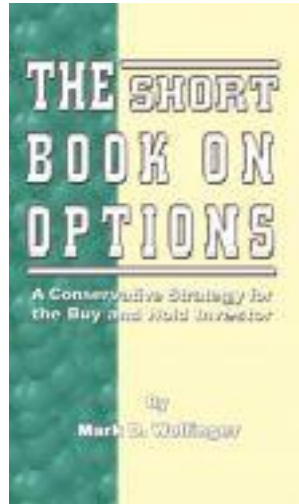
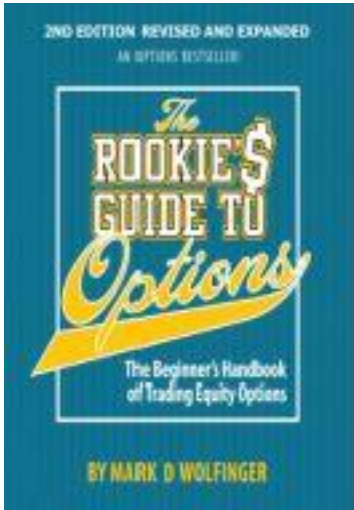
Other Books by Mark D Wolfinger

My Dead-Tree Books

The Rookies Guide to Options, 2nd Edition (2013)

Create your own Hedge Fund (2005)

The Short Book on Options (2002)



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Book One. (Volume 0) Intro to Options: The Basics (2014).

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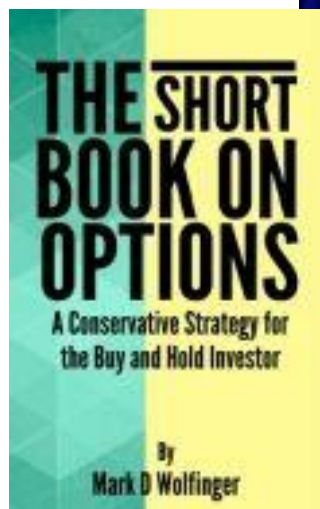
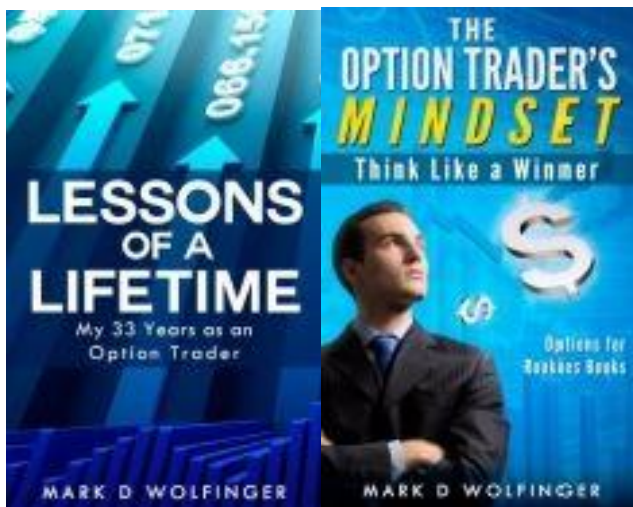
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My other eBooks:

The Short Book on Options (2002, 2014)

The Option Trader's Mindset: Think like a Winner (2012)

Lessons of a Lifetime: My 33 years as an Option Trader (2010)



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About the Author



Mark Wolfinger has been in the options business since 1977, starting as a market maker on the trading floor of the Chicago Board Options Exchange. He is now an author and educator of individual investors, specializing in the conservative use stock options.

Born in Brooklyn, New York in 1942, he currently resides in Evanston, Illinois with his life partner Penny.

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He writes on options for about.com: <http://options.about.com>

Table of Contents

Introduction
Chapter One
Chapter Two
Chapter Three
Chapter Four
Chapter Five
Chapter Six
Chapter Seven
Chapter Eight
Chapter Nine
Chapter Ten
Chapter Eleven
Chapter Twelve
Chapter Thirteen
Chapter Fourteen
Chapter Fifteen
Afterword